



REPORT ON INTERNAL CONTROL



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Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2006, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 7, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered FSA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determined whether internal control had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 06-03 and not to provide assurance on internal control. Accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures reported in the Management Discussion and Analysis of FSA's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

However, as a result of the procedures we did perform, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FSA's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described below.

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A material weakness, based on auditing standards generally accepted in the United States as established by the American Institute of Certified Public Accountants, is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described below is a material weakness.

FSA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for FSA's financial reporting needs. Specifically, FSA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing FSA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, FSA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers.

REPORTABLE CONDITIONS

1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition)

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements have been made over the last several years, particularly during fiscal year (FY) 2006, we noted that internal controls and processes surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined to ensure that appropriate estimates are prepared.



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In addition, the Credit Reform Workgroup (CRW), which was created in FY 2004 and consists of managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service, met on a consistent basis and were heavily involved throughout the credit reform process in FY 2006. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to credit reform, and to manage the development of improved processes, procedures, and sources of information to enhance the credit reform estimation process.

However, after identifying the key improvements made or currently being made by the Department during our testing of loan guarantees, allowance for subsidy, and subsidy cost estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the direct loan (DL) receivable and liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability account. The model uses multiple sources of loan data and hundreds of assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM for the prior year also produces a forecast of the expected cash flows in the current year for the outstanding loans. The new data analysis tools prepared by the Department support more disaggregated reviews of data by cohort. The Department's efforts in this regard are evolving, particularly in capturing the value of the new data analysis tool. These efforts have highlighted differences between recorded activity by cohort in the Department's records as compared to expected cash flows or cash flows derived from credit systems which merit further investigation.
- The early phase of the loan estimation process includes the development of the assumptions which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. While we understand some improvements have been made, we were informed that the programming language was not fully documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data. We continue to advocate completion of this process.



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- Particularly in areas that have relatively less predictive capability in the existing model, management should consider the use of reasonable simplified assumptions in estimate development, which can result in simpler programs, thus establishing transparency and limiting the potential for errors. The pattern of large re-estimates in the Department's programs, which reflect difficulties projecting future cash flows, can lead to a call for model enhancements which generate successively more complex and theoretically precise estimates. On balance, however, such refinements may do little to counteract the volatility of the estimates which are highly sensitive to changes in the underlying data. Introducing further complexity may create the appearance of further precision which is largely unwarranted due to the underlying volatility. Such changes, by further complicating the model and the process to develop the estimate, can also significantly increase the risk of errors in updating and running the model.
- FFEL program receivables are classified as pre-1992 loans (liquidating account loans) and post-1991 loans (financing account loans). The Department records certain collections on each of these loan categories using an estimation process (splitter process), as this information cannot be obtained directly from cash collections. The allocation of collections between liquidating and financing loans ultimately affects the liability account for loan guarantees and accounts payable to Treasury. Currently, the Department relies primarily on the output of the credit reform model to record the net value of the pre-1992 loans. The Department's financial systems are not configured to account for cash flows on a rigorous cohort level. As noted earlier, some improvements have been achieved with the development of certain aspects of cohort level analysis. Accurate cohort-level data is increasingly important to ensure that estimates in the subsidy models are appropriately adjusted as cohorts from the early 1990s wind down, and cash flows from default activities create temporary demands for cash that are currently funded on an aggregate basis across cohorts. The process may ultimately help resolve the splitter issues discussed above.



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- The Department continues to be challenged in estimating lender and borrower behavior, and relies significantly on prior patterns to estimate future activity. There may be situations, however, in which a refinement of such estimates should be made if circumstances suggest that the pattern will not repeat. Due to lags in the receipt of information on consolidation loans, the Department did not accurately estimate the split between in-school and out-of-school borrowers who consolidated in developing FY 2005 subsidy rates. When actual figures were known, it was determined that the Department had underestimated in-school consolidations, resulting in a re-estimate during FY 2006. Interest rates for in-school borrowers were much lower than for borrowers who were out of school, resulting in an increased subsidy for FY 2006.

While patterns in the SLM reflect historical data, it seems possible that the level of consolidations will decrease significantly in the future, since many of the incentives for borrowers to consolidate, such as locking in lower interest rates in a rising interest rate environment, are no longer available. High consolidation volume has potentially artificially masked long term loan defaults and potential write-offs, since the consolidation process pays off the old loan and establishes a new loan. While the Department's approach is data based, users of the estimates should be made aware of the significant volatility of the estimates and potential for significant future re-estimates as the program changes take effect, the interest rate environment changes and actual default losses become more readily determined.

Recommendations:

We recommend that Federal Student Aid perform the following:

1. Continue to improve the analytical tools used for the loan estimation process. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.
2. Document, in detail, the programs written to develop the assumptions for the SLM and document scenarios under which deviation from patterns of prior cash flows are appropriate.
3. FSA should coordinate with the Department to continue to develop detailed operating procedures for the loan estimation process, which would include the step-by-step procedures that take place during the various phases of the process.
4. Efforts to more fully implement cohort reporting should continue, with specific research on whether balances in the Department's and FSA's financial records are supported by estimates, by cohort, from the SLM and the newly developed cohort analysis tool. Analytical tools should be developed to assure that the splitter process is operating as intended and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts.



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2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)

In connection with the annual audit of FSA's FY 2006 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, the GAO publication states that:

- "management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management," and
- "internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved."

While the Department and FSA have made progress in strengthening controls over information technology processes and have continued making improvements in the areas of configuration management, virus protection, and security patch management during FY 2006, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses, including several that were repeat conditions, within information technology security and systems that need to be addressed.

More specifically the Department and FSA should: (1) strengthen access controls to protect mission critical systems (e.g. user provisioning process, periodic access revalidation, timely removal of user access, physical data center access controls); (2) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; (3) enforce the use of complex passwords in all systems across the organization; (4) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the



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security weaknesses across the organization; (5) implement consistent tape back up controls; (6) strengthen security incident handling procedures and intrusion detection systems; (7) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location or a new system; (8) improve private data protection controls (e.g. proper disclosure of the use of 'cookies' on Department and FSA websites and policies and procedures on dial up access and encryption of back up data); (9) enhance its security training and awareness program and the monitoring of this program, specifically in accounting for completion of such training by all employees and contractors; (10) improve protection of sensitive information, including read-only access to personally identifiable information on Department and FSA systems; and (11) the Office of Management should continue its efforts to reconstruct its inventory database or otherwise reconcile its physical inventory of computing and other equipment to ensure that all Department and FSA computing resources and the data residing in them are secured and safeguarded.

The OIG has identified significant deficiencies for the Department in its 2006 Federal Information Security Management Act (FISMA) report in the areas of (1) the Department's management control structure in incident handling and intrusion detection systems which restrict its ability to reasonably identify and report suspicious activity occurring on the Department's and FSA's systems; and (2) the Department's and FSA's configuration management program that restricts its ability to reasonably maintain security over its systems in a consistent manner. In addition, a number of repeat conditions were noted in our work and in the OIG's audit reports, an indication that the control environment and monitoring components of internal controls at the Department and FSA require additional focus.

Recommendation:

1. Audit resolution activities have traditionally been focused around addressing the immediate security and control weaknesses identified by audit reports rather than a detailed evaluation of the root cause for the identified weaknesses, which is indicated by the number of repeat findings. We recommend that the Department and FSA continue efforts to address security and control weaknesses disclosed in audit reports or identified in internal self-assessments with an emphasis on addressing the root cause of the security or control weakness, which should decrease the likelihood of a similar weaknesses being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, updates to procedures to ensure proper configuration of servers against documented hardening standards at the time of deployment, and auditing performance-based contracts of vendors providing system support services to the Department and FSA.



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STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2005 audit of the Federal Student Aid financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Summary of FY 2005 Reportable Conditions

Issue Area	Summary Control Issue	FY 2006 Status
Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Reportable Condition)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Improvements noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements noted – Modified Repeat Condition Reportable Condition

We have reviewed our findings and recommendations with FSA management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 7, 2006.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

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November 7, 2006